11 July 2012

Westpac Institutional Bank

Power house

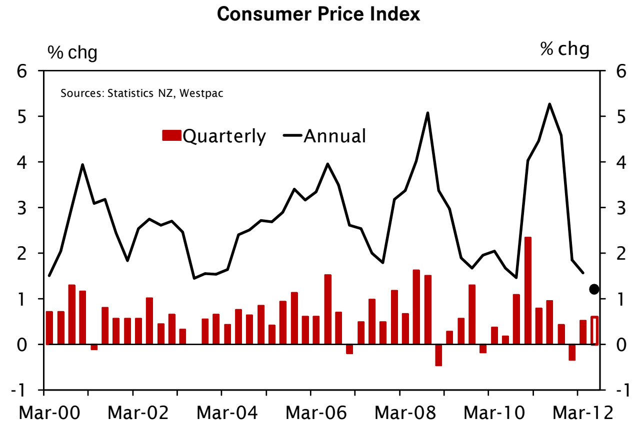
Q2 CPI preview: 17 July, 10:45am

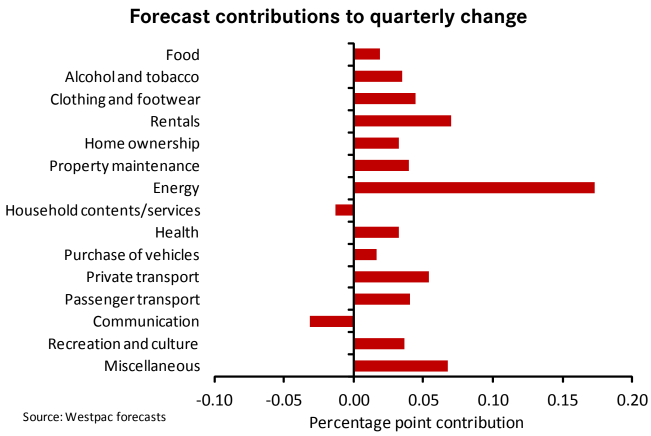
- **We estimate that consumer prices rose 0.6% in the June quarter, bringing annual inflation down from 1.6% to 1.2%.**
- **A sharp hike in electricity prices accounts for a large share of the increase.**
- **Watch for further housing-related inflation, as house prices rise and the Canterbury rebuild puts pressure on resources.**

Summary

Our estimate of a 0.6% rise in consumer prices is relatively subdued for a June quarter – the ten-year average has been 0.9% – and reflects the lingering impact of the high New Zealand dollar and smaller-than-usual increases in food and fuel prices. This result, plus the legacy of the surprisingly soft outturns in the second half of 2011, means that annual inflation will veer even closer to the bottom of the Reserve Bank's medium-term target range of 1-3%.

The quarterly details of the CPI are quite idiosyncratic, but we think there's one particular detail worth watching: the rate of growth in housing-related costs, as the Canterbury rebuild picks up and house prices start to increase nationwide. The subdued pace of overall inflation means that the RBNZ has the flexibility to look past these pressures in the short term – but any emergence of price pressures even at this early stage of the rebuild process, and in this relatively modest housing upturn, should serve as a warning about longer-term inflation prospects.





Details

We expect a broad range of small contributions to June quarter inflation, with the standout item being an estimated 3.9% rise in energy prices – larger than any quarterly increase on record. This resulted from a significant increase in electricity line charges to fund a major investment in the national grid.

We've assumed further gains in housing-related costs in the June quarter: that is, new housing, property maintenance, rents and real estate services. While we've spelled out the case for more housing-related inflation over time, picking the impact on any given quarter is still something of a lottery, based on recent experience. Housing inflation was remarkably strong in the first half of last year, unexpectedly petered out in the second half, then roared back again in the March quarter of this year.

We expect a relatively soft 0.1% rise in food prices for the quarter (figures for the June month are out tomorrow). Food prices typically rise in the June quarter, but meat and grocery prices fell this time as weaker world commodity prices over the last year took their toll. In contrast, fresh produce prices now seem to be heading higher again.

There was also a relatively small 0.6% average increase in fuel prices, which typically rise through the first half of the year. After reaching near-record highs through April and May, petrol prices fell sharply in June – which also sets up a soft starting point for the September quarter.

Regular seasonal contributions will include a rise in clothing and international airfares and a fall in accommodation. In terms of irregular factors, we've assumed that the 14% drop in book prices in the March quarter will be reversed (it reflected a quirk in the mix of bestselling fiction titles rather than any outright drop in prices) and that used car prices will rise, albeit at a slower pace than in the last year, following the tightening of emissions standards in January. The strong New Zealand dollar will continue to suppress prices for many household goods – although this effect is likely to be fading, as the currency no longer has the consistent upward momentum that it showed from mid-2009 to mid-2011.

Market implications

Subdued inflation will be the theme for a while longer. We expect annual inflation to bottom out in either the June or September quarters; it's possible that it could briefly drop below the lower edge of the 1-3% target range, though it's not in our current forecasts – how fuel prices pan out over the current quarter will be the deciding factor. Beyond this, we expect inflation to return above the 2% midpoint by the middle of next year.

Our inflation forecasts are not markedly different from the RBNZ's over the near term, and we don't expect the June quarter outturn to have much impact on the language of the next OCR review statement on 26 July. Cost pressures generated by the Christchurch rebuild will become a more significant factor over time, although the weak starting point for inflation means that the RBNZ will be in no hurry to start pre-emptively leaning against these pressures.

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